Allegheny Power
10435 Downsville Pike
Hagerstown, MD 21740
(301) 790-3400

Writer's Direct Line: (724) 838-6654
FAX: (724) 830-5174

May 23, 2003

Mr. David R. Eichenlaub
Assistant Director, Division of Economics and Finance
Virginia State Corporation Commission
Tyler Building, 4th Floor
1300 East Main Street
Richmond, VA 23219

Dear Mr. Eichenlaub:

The Potomac Edison Company dba Allegheny Power ("AP" or "the Company") appreciates the opportunity to respond to your letter of April 16, 2003 concerning the Commission's report to the Legislative Transition Task Force ("LTTF") and the Governor under § 56-596 B of the Virginia Electric Utility Restructuring Act ("the Act").

AP commends the Commission Staff on its willingness to solicit and consider ideas from all stakeholders in this process. This facilitative approach has worked successfully with other matters in the past. AP looks forward to continuing to lend its experience with retail access in the states of Pennsylvania, Maryland, and Ohio to the Commission in a constructive way to facilitate effective competition in Virginia.

AP would like to offer the following comments and recommendations in response to the specific questions posed in your April 16, 2003 letter. Each of these questions is listed below, followed by AP's comments and recommendations.

Question 1: What are the current obstacles to the development of a robust competitive retail electricity market for residential customers? For commercial and industrial customers? How can these obstacles be overcome?

Wholesale and retail price dislocation is a significant obstacle to the development of a competitive market. Rate caps serve to protect customers during the transition period, but the same rate caps also insulate retail consumers from the reality of pricing variability that exists in the wholesale market. This obstacle will be removed when rate caps are removed, at which point the generation component of default service rates will be based on competitive market prices.

Another obstacle to the development of competition is the need for a wholesale power exchange, including real-time energy markets. Real-time energy markets provide an alternative to the purchase of load following products when supplying a retail load-shape.

A third obstacle is the absence of demand response to price. Demand response to price is a key fundamental which is missing in the retail electricity markets. The introduction of demand elasticity based on price, such as real-time pricing, will result in lower market clearing prices, as load will diminish as prices rise.

Lastly, as PE's capped rates in Virginia are, for the most part, below current market rates, the transition period, as currently defined, is not facilitating a transition. While PE fully appreciates the need and desire for consumer protections as the market develops, the SCC should continue to seek a balance between price protection (rate caps) and market development.

Question 2: With respect to potential obstacles, what is the outlook for future natural gas prices and the impact on wholesale electricity prices and a competitive retail market? Please comment on the postulation by several natural gas industry experts of a growing structural demand/supply imbalance with demand outstripping supply over the next several years. What actions, if any, could be taken to mitigate the potential impact of an over-dependence on a single fuel source?

As environmental concerns drive natural gas as the fuel of choice for new generating sources, there will be an increasing convergence of electricity and natural gas prices. Traditionally, natural gas-fired peaking facilities set the marginal cost of electricity only during summer peaking conditions. However, with the establishment of NOx regulations, over-firing of coal boilers and the construction of intermediate natural gas generation facilities (combined cycle) have resulted in natural gas setting the marginal cost of electricity more hours of the year, both on-peak and off-peak. Further, with the volatility of summer prices, outages on base-load generation are taken in non-peak periods (spring and fall shoulder peak months), which causes natural gas facilities to supplant this capacity during periods of unseasonal weather in the spring and fall, again increasing the number of hours per year that natural gas sets the marginal cost of electricity.

To reduce single-fuel dependence and convergence into the future, consideration should be given to a revised national energy strategy that encourages fuel source diversity.

Question 3: In light of recent legislation, how can the Commonwealth be assured of a continuing reliable electricity system when control of transmission is governed by an RTO?

FERC's recent "white paper" set out some important intended changes to its proposed Standard Market Design. FERC clarifies that nothing in its Final Rule will change state authority over resource adequacy and regional transmission planning. Although FERC will require public utilities to join an RTO or ISO, it appears the states will continue to play a significant role in the planning and resource adequacy processes.

What factors should be considered during the cost/benefit analysis required prior to Commission approval?

RTO formation and membership is driven conceptually by the need for open and comparative access to the transmission system for all market participants. It facilitates the efficiency of the wholesale electric marketplace, which in turn supports the possible development of localized retail competitive markets. As such the benefits of RTO membership fall to a broader area, beyond the boundaries of any particular state. Accordingly, any cost/benefit analysis should encompass the regional area. Items that should be included are:

- Regional deliverability of the existing transmission infrastructure and the effect of congestion management mechanisms on the broad wholesale market
- Comparison of regional resource adequacy to more local jurisdictional resource adequacy and estimate of cost to equalize same
- Cost of provision of localized redundancy to assure system security as compared to the current reliance on the regional system to provide that backup
- Cost of RTO operation compared against multiple operational staffs in individual utilities

Question 4: Later this month, the Federal Energy Regulatory Commission is expected to issue its "white paper" addressing certain issues debated the past several months regarding Wholesale Electric Standard Market Design (SMD). Additionally, the Department of Energy is expected to issue the results of its cost/benefit analyses of the impacts of SMD. Please provide your initial thoughts and reaction to such releases and identify any significant issues of concern.

AP is currently reviewing the FERC "white paper" regarding Wholesale Electric Standard Market Design as well as the DOE cost/benefit analysis of the impacts of SMD. AP will provide copies of any comments filed with FERC. Attached at the end of this document is a summary of AP's previous positions on SMD, which were filed prior to the recent "white paper".

Question 5: Are the Commission's Rules Governing Retail Access to Competitive Energy Services conducive to promoting effective competition in the Commonwealth? If no, how should they be modified? Is there any way in which these rules can or should be improved, in any event?

The Commission's Rules Governing Retail Access to Competitive Energy Services ("Rules") are conducive to promoting the advancement of effective competition in Virginia. The Rules strike an appropriate balance of all stakeholder interests by providing consumer protections while ensuring equal treatment of all market participants. Based on AP's experience with similar rules in Maryland, Pennsylvania, and Ohio, the Company believes the Rules will serve as an effective framework for retail access. AP recommends no changes to the Commission's Rules.

Question 6: What should be the level of consumer education when the program is resumed on July 1, 2004? Should it be as visible, more visible or less visible than when the campaign was suspended? Upon resumption of the campaign, what focus, theme or message should

be communicated? Since TV advertising is the most expensive component of the program, what level of TV advertising should be included in the resumption of the campaign?

It is AP's understanding that the primary purpose of the initial advertising campaign was to create interest among consumers and inform them that educational materials are available free of charge. AP feels this is an appropriate focus for the campaign again once it is resumed. Given the limited number of suppliers offering service in Virginia, it may be appropriate at this time to utilize less expensive forms of communication than TV advertising. AP recommends the VEC toll-free information line and the VEC website at www.yesvachoice.com remain available for customers to obtain factual and unbiased information on customer choice.

Question 7: Are there any other actions that have been taken or are being considered in other states that may be used to advance competitive activity in Virginia?

AP encourages the Commission to explore wholesale competitive bidding of default service after the rate cap period ends in Virginia. Currently there is a Maryland proceeding underway to define such a procedure for wholesale bidding of default service at the end of the utilities' rate cap periods in that state. The Maryland Public Service Commission recently approved Phase I of the Settlement Agreement in Case No. 8908, *Standard Offer Service*, which was negotiated between Maryland's utilities, the Maryland PSC Staff, consumer groups and various wholesale and retail suppliers. The Settlement Agreement defines a procedure for the provision of default service to customers through the competitive selection of wholesale supply. The settlement makes such services available at market prices, benefiting all stakeholders. Retail suppliers are allowed to effectively compete for load, thereby stimulating the competitive market with no penalty to customers. Customers are afforded protections beyond the assurances required by Maryland's restructuring statute, while permitting utilities to recover their verifiable, prudently incurred costs to procure the electricity plus a reasonable return.

AP is an active participant in the Commission's work group established in Case No. PUE-2002-00645, *In the Matter Concerning the Provision of Default Service to Retail Customers Under the Provisions of the Virginia Electric Utility Restructuring Act,* and as such the Company has and will continue to share its views on this matter in that forum. In addition, a proposed competitive bidding process is also underway in AP's Ohio jurisdiction. As the Commission develops its recommendations on the important issue of default service, AP looks forward to offering its experiences in both the states of Maryland and Ohio.

AP would also like to point out that while the continuation of the capped rate service may provide short-term protection to consumers, it has also insulated the customer from the pricing variability that exists in the wholesale market. As previously recommended, AP believes that the Electricity Supply service provided by the incumbent utility during the period from January 1, 2004 until July 1, 2007 should be more reflective of the current market prices for wholesale supply. AP has previously proposed alternatives to Staff for consideration and again offers its assistance and support in developing solutions to enhance market development during the remainder of the capped rate period.

Question 8: Do you have any ideas that have not been tried elsewhere that may facilitate competitive activity in Virginia?

AP has no response to this question at this time.

Closing

AP appreciates the opportunity to offer its views and recommendations regarding these issues. Thank you for giving us this opportunity, and please feel free to contact me for further information. AP looks forward to working with Staff to further develop and refine the Commission's recommendations on these very important issues.

Sincerely,

Cynthia A. Menhorn

Cynthia A. Menhorn
General Manager
Regulated Pricing Services

SUMMARY OF ALLEGHENY POSITIONS ON FERC PROPOSED RULEMAKING TO STANDARDIZE MARKET DESIGN ("SMD")

Allegheny Power and Allegheny Energy Supply Company, LLC (Allegheny Companies) support FERC's initiative to standardize transmission access and market design nationally, but suggest that FERC make the following improvements to SMD:

- Protect retail customers against the risk of new transmission congestion costs and service interruptions through allocations of "congestion revenue rights" ("CRRs"). CRRs must "follow the load" (*i.e.*, the right to CRR revenues belong to load and other entities that pay for the fixed costs of the transmission system). CRRs should permit transmission, supply and demand response solutions to compete on an equal footing to resolve congestion.

- FERC must respect the sanctity of contracts, such as pre-Order No. 888 contracts between utilities and their customers. FERC could provide incentives for customers to convert their service entitlements after a four-year transition period (similar to FERC's proposed transition period for placing bundled retail service under the new SMD tariff), as long as FERC provides utilities the opportunity to recover lost revenues.[1]

- FERC generally should not require "participant funding" (*i.e.*, incremental pricing) for new facilities integrated with the AC transmission grid because it is virtually impossible to identify discrete beneficiaries of such projects for the life of the facilities. FERC should permit participant funding for: (1) merchant projects to build DC facilities, and (2) AC projects only when an appropriate load flow study identifies discrete project beneficiaries for the life of the facilities.

- FERC should not mandate immediate implementation of postage stamp rates within the Independent Transmission Provider's ("ITP") system, but instead should encourage a transition from license plate rates over a period of years by permitting transmission owners to recover their lost revenues, or by pricing new construction on a postage stamp basis.

- Concerning resource adequacy, FERC should: (1) require ITPs to adopt reasonable planning horizons of three to five years, (2) permit ITPs to adopt resource adequacy requirements through the stakeholder process, with a minimum default reserve capacity requirement based on application of the North American Electric Reliability Council's

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1 Incentives could include, for example, a stranded cost surcharge for the utility to recover lost revenues similar to the mechanism FERC accepted to allow Allegheny to recover lost through-and-out charges when it joined PJM through PJM West.

one-day in ten year probability of lost load standard, (3) facilitate retail access by permitting ITPs to adopt resource adequacy procurement periods that reflect the rights of retail load periodically to switch suppliers, (4) require ITPs to allocate the resource adequacy reserve requirement to load serving entities ("LSE") based on each LSE's load ratio share of the reserve capacity requirement, (5) require ITPs to develop resource adequacy verification procedures, (6) require ITPs to adopt meaningful deficiency penalties to make it uneconomic for LSEs who fail to meet their reserve capacity obligation, (7) adopt a must-offer requirement for capacity resources to ensure that a contracted resource is actually offered into the market, and (8) require resources (generation or demand response) to demonstrate the ability to perform.

- FERC should promote demand response programs while making clear that: (1) the ITP cannot offer demand response options directly to retail customers because that would make it a market participant, (2) LSEs, not third party aggregators, can sell demand response services so that LSEs will not be saddled with imbalance payment responsibility, and (3) demand response should not be subsidized by above-market payments that are socialized as uplift.

- FERC should delegate only limited ITP functions to independent transmission companies and only on a trial basis because ITCs are, by their nature, market participants whose interests are biased by their profit-making objectives.

- FERC needs to be careful to avoid an improper delegation of exclusive Federal authority over interstate transmission and wholesale power sales to the States through Regional State Advisory Committees

- FERC should not adopt a new definition of "market power" that could undermine confidence in the sanctity of power contracts. FERC should continue to apply the definition of market power that it has used for many years which depends on the ability of a supplier to impose a significant price increase for a significant period of time. FERC should not impose excessive bid caps or market price mitigation because such restrictions distort the market and undermine investment decisions, to the detriment of consumers in the long term. FERC should reexamine annually any mitigation measures it adopts for an ITP to determine whether the mitigation continues to be necessary in light of demand response and resource adequacy developments.

The Allegheny Companies suggested that FERC provide for a comprehensive review of SMD implementation after a reasonable time period.